SECTION THREE WRITTEN TESTIMONY SUBMITTED BY WITNESSES

MEMO

TO:

Senate Banking, Finance and Insurance Committee

FROM:

Ed Smith, Jr., CEO, Plaza Financial

DATE:

January 31, 2007

SUBJECT:

Remarks for Senate Banking and Finance Hearing

Mr. Chair and members. I would like to thank you for inviting me to take part in this hearing and provide background information on nontraditional mortgage products.

As mentioned, my name is Ed Smith Jr. and I serve in a leadership role with the California Association of Mortgage Brokers. However, I do not come here today wearing that hat. I come to you today as a mortgage broker from San Diego with over 20 years of on the ground experience in all mortgage loan products. I am in the trenches everyday, helping residents in the state of California achieve the American Dream of Homeownership.

The topic of today's hearing, nontraditional residential mortgage products, is an issue I have been working on extensively as an individual loan originator.

The very basic definition of nontraditional loans, which are sometimes referred to as exotic or alternative loans, is any loan product that does not fall into the 30-year fixed loan that has a set interest rate and set payments until the loan is fully paid.

Housing costs have skyrocketed for so many working families, and these nontraditional loans are the only way people could realize the benefit of homeownership. These loan products are the bridge for helping these families endure California's housing affordability crisis and face a brighter future by obtaining a home they can call their own.

Within the nontraditional loan category, there are many types of nontraditional loans crafted to meet the needs of an ever complex marketplace. I will focus on the three most prevalent nontraditional products used by consumers today. They are the 2/28's, Payment-option adjustable rate mortgages, and 40/50 year loans.

2/28s: Also known as hybrid ARMs, these are loans in which the borrower owes a low, fixed rate for the first two years. These loans reset after the 24th month into adjustable rate mortgages that typically readjust every six months. Evidence suggests that 2/28s are the most popular form of subprime loan in today's market. Similar hybrid ARMs that provide different amounts of time before the fixed period resets include 3/27s, 5/25s, and 7/23s.

Payment-option: Also known as option loans, these loans typically give the borrower a choice of four different amounts to pay each month. The four options: 1) a payment that covers none of the principal and only part of the interest due, allowing the loan to negatively amortize; 2) an interest-only payment; 3) a

principal and interest payment based on a 30-year amortizing loan; and 4) a principal and interest payment based on a 15-year amortizing loan.

Typically, a negatively amortizing loan will recast when the interest due reaches 120% or 125% of the original loan amount, or after 5 years if the principal balance is greater than the original loan amount, depending on the terms of the loan (some loans recast at 110% of the original loan amount). When the loan recasts, the borrower is required to begin paying principal and interest that are amortized over the remaining years of the loan. (For example, if an individual chooses to make minimum payments for five years, and the loan recasts at the end of the five-year period, further payments would be amortized over the remaining 25 years of the loan, requiring the borrower to pay back all of the accrued principal, plus all of the deferred interest over 25 years).

Borrowers whose loans negatively amortize may or may not know by how much their debt is increasing each month. Lenders are currently under no requirements to inform borrowers of the extent of their negative amortization. Many payment-option loans also have built-in recasting periods (typically every five years) that kick in, even if the home has not negatively amortized to a certain trigger level.

As noted above in the description of interest-only loans, an individual with a payment-option mortgage who chooses to make interest-only payments will eventually be required to make payments that begin to pay down the principal. Payment-option adjustable rate mortgages (ARMs) in which a borrower selects to pay interest-only behave much the same as regular (non payment-option) interest-only loans.

Most payment-option mortgages are adjustable, although some lenders have introduced payment-option fixed rate mortgages.

40- and 50-year mortgages: These mortgages are not nontraditional according to the definition provided above (i.e., they do not allow borrowers to defer payment of principal or interest), but they do allow borrowers to spread their principal payments over a time period longer than 30 years. Like nontraditional mortgages, 40- and 50-year mortgages allow borrowers to "buy more house" than they would be able to with a 30-year fixed rate mortgage, because the lengthier amortization period lowers their monthly payments to a more affordable level.

With these various loan products and payment options, today's market provides a loan for virtually every kind of buyer. As a loan originator with over 20 years of experience, I have seen firsthand the benefits of these products for certain individuals. By limiting product options, we are limiting access to homeownership, thus creating a subset of renters within our great state and destroying the American Dream of Homeownership.

While the concept of more legislation for these products would seem the best route to take, the mortgage industry has taken upon itself to regulate the use of these products by creating our own internal regulation. For example, the California Association of Mortgage Brokers recently created a detailed, proprietary Consumer Protection and Education Worksheet. This worksheet is a carefully structured questionnaire a broker and customer walk through together step-by-step to ensure the borrower is fully informed of the loan product they are taking.

It is the responsibility of both broker and borrower to make sure that the terms of a consumer's loan is understood. This worksheet provides an avenue where the average consumer can sit down with a certified, licensed broker and map out the appropriate loan product for their circumstances. In laymen's terms, Education is the key.

As I stated earlier, for many buyers nontraditional loans are the only manner in which some will achieve their dream of home ownership. The benefits of nontraditional loan products have been immeasurable. For many it has literally made the difference to attain home affordability and home ownership.

Again, thank you for inviting me here today and I would be happy to answer any questions the committee has at this time.

Glossary of Nontraditional Mortgage Products

Nontraditional loans are those that allow borrowers to defer repayment of principal, and in some cases, interest. These loans are also known as "alternative" or "exotic" mortgages. Borrowers who obtain these loans are given the opportunity to make relatively low payments during an initial low interest rate period in exchange for agreeing to make much higher payments during a later amortization period. Nontraditional loans are sold in the prime, alt-A, and subprime markets. Subprime borrowers generally pay interest rates at least 3% higher than prime borrowers, and sometimes much higher.

Nonprime borrowers are any borrower who does not qualify for prime interest rates, usually because their credit score (e.g. FICO score) falls below a threshold level. Although lenders do use factors other than FICO scores to determine whether a borrower can qualify for a prime loan, FICO scores remain the single most important factor in determining whether a borrower falls into the prime pool (generally, FICO scores of 660-680 and above) or the nonprime pool (generally, FICO scores below 660). The nonprime pool of borrowers includes both Alt-A and subprime borrowers.

The Alt-A market lies somewhere between prime and subprime and is populated by borrowers who might have good credit, but who don't necessarily fit traditional lending standards. Examples include people with very short credit histories, self-employed individuals whose income might not appear neatly on a W-2, and people who receive large amounts of their income through tips or bonuses, among others. Because of their better credit as compared to subprime borrowers, Alt-A borrowers are often considered appropriate recipients of reduced documentation loans and piggyback loans (see definitions below and statistics later in this paper).

Initial teaser rates are low introductory rates intended to increase the affordability of a loan in its early years. It is not uncommon for loan interest to increase by 6 percentage points or more from an initial teaser rate to a fully-indexed rate, although many loans have interest rate caps that prevent the interest rate from jumping more than a few percentage points each time the loan resets to a higher rate.

Interest-only loans are loans in which a borrower may defer payment of principal during an initial interest-only period. The interest-only period typically lasts between three and ten years. During this time, interest payments may be fixed or variable, depending on the loan. After the initial interest-only period ends, borrowers must begin to pay principal, and the principal is amortized over the remainder of the loan (For example, if a borrower obtained a 30-year interest-only loan and paid no principal during the first five years of the loan, the full amount of the principal would be amortized over the remaining 25 years of the loan).

Negative amortization describes a loan in which the principal balance increases, rather than decreases, over time.

Piggyback, also known as simultaneous second-lien loans or wrap-arounds, piggybacks are second mortgages, either open or closed lines of credit, that are taken out at the same time as a primary mortgage. They allow a buyer to purchase a home with little or no money down, and to avoid paying mortgage insurance. Piggy backs are commonly designed to wrap around a primary mortgage that covers 80% of

the home's cost. The piggy backs in this case cover 10% to 20% of the remaining cost of the home. The down payment accounts for any amount not covered by the first lien and the piggy back.

Silent seconds are piggyback loans whose existence is not involved in underwriting the primary loan (e.g., when the loan-to-value ratio used by a lender to qualify a borrower for the first lien includes only the first mortgage).

Reduced-documentation loans are a class of loans commonly referred to as "stated-income," "state asset," "no-doc," or "low-doc" loans. These loans generally allow borrowers to verbally state the income and assets they will have at their disposal to pay off their mortgages, rather than requiring them to submit copies of their W-2s and/or provide copies of past income tax returns. These loans come in several different types, a few of which are listed immediately below. Reduced-documentation loans often carry higher interest rates than those with full documentation.

NINA is short for no income, no assets. NINA is a type of stated-income loan in which the borrower is not required to provide documentation regarding his or her income or assets.

NINJA is short for no income, no job or assets. In a loan of this type, a borrower is not required to provide documentation of their income or assets, and the individual's employer is not called to verify their employment.

No ratio is a loan in which the underwriter does not look at a borrower's income, but does look at a borrower's assets. It is called a no ratio loan, because there is no debt-to-income ratio reviewed during underwriting.



CALIFORNIA ASSOCIATION OF MORTGAGE BROKERS (CAMB) CONSUMER EDUCATION AND PROTECTION WORKSHEET

	iping bor	owers Select Their Best Mortgage Fit	
uyer Name:ddress:			
ddress:elephone:elephone:		Email	
he objective of this worksheet is for the prospection and empower	ve borrower rs the broker section than	and broker to have an educational dialogue that enables the borrower to fit the borrower to fit best possible loan. The broker and borrower lughly, and the broker should answer every question so the borrower li	
BORROWER'S GOALS that are the borrower's goals and reasons for this	financing?	VI. MORTGAGE OPTIONS Following are available mortgage options. The broker will	
Are you purchasing or refinancing? If refinancing, why? What is most important to you about this mortgage? What is your financial goal?		provide an overview, including advantages and disadvantages of the appropriate program(s). Both the borrower and the broi should initial, indicating you, the borrower understand what explained.	
		 Arm v. fixed (5 year, 30 year, 40 year, 50 year, other) Hybrid v. fixed (5 year, 30 year, 40 year, 50 year, other) 	
Rank the following in order of importance (1 important, 4 being least important) Payment amountLoan Amount Cost	1.50	Interest Only Loans Monthly Payments Principal Balances Pick a Payment	
Cost Interest rate Down payment amount How long do you intend to live in the home Will you be saving for educational expenses	D Vac. D N	 How each loan/payment works Does my payment fluctuate and when will it fluctuate? How long will it take to build equity? How long to pay off my loan? 	
Will you be saving for retirement? How many years before you plan on retiring? Will you consolidate debt?	O Yes O No	VII. MORTGAGE LOAN DISCLOSURE	
Will you consolidate debt? Discussion on priorities:		("Truth in Lending" and "Mortgage Loan Disclosure Statemen regarding the costs of the mortgage.	
BORROWER'S CURRENT FINANCIAL STATU usider your current outstanding debts, employm	S	Did you read and understand the Truth in Lending form? Did you read and understand the Mortgage Loan Disclosure Statement □ Yes □ No	
d other financial factors. Credit score Source/Date of Score Total amount of consumer credit debt:		VIII. BROKER RECOMMENDATION The goal of this section is to list the recommended program. The is no guaranteed approval for a loan because of other informat that may not be known at this time.	
Attach a list of credit if applicable My gross monthly income is \$ Decline to State:	T Var. D No	The recommended program: Purchase Price: Down Payment:	
Can you verify all your assets? Can you verify all your assets? Income and Employment History:	Yes O No	Loan Amount: Fully Indexed Rate: Payment Rate: Term:	
How much monthly housing expense are you cowith, including property tax and insurance? Estimated debt to income ratio: housing total debt	omfortable	Adjustment Period: Index: Margin: Life Interest Cap: Per Adjustment Cap:	
BORROWER'S LOAN AMOUNT ESTIMATE to goal of this section is to estimate how much you row. Compare what you can afford with what you will be comfortable spending:	can afford to bu want to b	Fees: Other: Why this option is recommended:	
How much money are you able to invest in a do	own payment		
if any? \$ Are you going to borrow money to make a dow and if so, from where?	n payment, I Yes 🛛 No	Additional explanation:	
PRE-APPROVED vs. PRE-QUALIFIED MORTG approved consists of credit and application review remarker and a written approval from the lender a amount. Pre-qualified consists of a verbal convoker who provides an estimate of the amount you.	ew by an for a specific ersation with	Borrower's initials:(Borrower understands the term IX. BORROWER'S DECISION List reasons why the borrower chose this program and if it differ from what was recommended: Decided on as the best option If the option differs from the broker's choice, list reasons where the program is the second of the option differs from the broker's choice, list reasons where the program is the second of the program is the progr	
Are you pre-approved or pre-qualified for a mortgage? For how much: Type of loan	Yes 🗆 No	a different option was chosen:	
60 MONTH ANALYSIS goal of this section is to project to the best of you re you will be financially in the future. Keep in n ntial expected changes in your financial standing	er ability nind any 3:	X. COMMENTS Additional comments and borrower feedback. • After counsel, borrower chose to, not to	
In the next 2-5 years, I estimate my income to be: \$	or decrease	After counsel, borrower chose to, not to accept my recommendation. Additional Comments: (Why You Chose or did not choose the recommendation)	
in the coming years?	to be to construct		
college education (attach separate list if needed):	, job location		
conlege education (attach separate list if needed):			

Statement of

Richard Fikani

Head of Retail Mortgage and Credit Operations Wachovia Bank

Before the Committee on

Banking, Finance and Insurance

Informational Hearing on

Non-Traditional Residential Mortgage Products

January 31, 2007

Chairman Machado, Vice Chairman Runner and members of the Banking, Finance and Insurance Committee, good morning. I appreciate the opportunity to appear on the panel this afternoon to discuss the alternative products that are available in today's mortgage marketplace. My name is Rich Fikani, and I am head of Retail Mortgage and Credit Operations for Wachovia Bank. In that capacity, I'm responsible for all mortgage fulfillment within the General Bank and all mortgage servicing operations for the entire corporation. I also oversee Wachovia's Internet, telephone and employee origination channels. I had similar responsibilities for World Savings, which last fall became a subsidiary of Wachovia.

Wachovia Corporation is one of the largest providers of financial services to retail, brokerage and corporate customers throughout the United States, with assets of \$700 billion. Its four core businesses, the General Bank, Capital Management, Wealth Management, and the Corporate and Investment Bank, serve 15 million households and businesses. Wachovia's full-service brokerage unit, Wachovia Securities, LLC, serves clients in 49 states. Wachovia's mortgage lending affiliates conduct mortgage lending in 50 states and the District of Columbia.

Since the acquisition of World and its parent company, Golden West Financial Corporation, Wachovia is pleased to now be one of the largest banking companies in California as well. Because we are still in the process of integrating World's operations with Wachovia's, and because World had a relatively larger mortgage business including substantial experience with its Option ARM product, my remarks today reflect World's mortgage lending experience.

Alternative mortgage products encompass a variety of financing options which have been developed to increase flexibility and affordability and otherwise meet the needs of many mortgage borrowers. While these products are often characterized as "new" and have been called "non-traditional," many of them have been around for decades, including those offered by World. Other members of the panels will probably discuss related issues that may be of interest to you today, but I will focus on the Option ARM product that has been World's specialty. We have been making such ARMs for 25 years, and as I'll discuss, we – and our borrowers – have found them to be extremely successful. While we offer other types of loans, more than 90% of our loan originations over the past two decades have been Option ARMs.

First, let me define the standard loan product we now offer: it's an adjustable rate mortgage for which payments are fixed annually while rates adjust monthly, based on an index. We provide each borrower several options each month regarding the payment he or she can make, including the full principal and interest payment; an option to pay down faster with a 15 year amortized payment; an option to pay only the amount of interest due on the mortgage; and an option to pay an amount which is less than the interest due and which will result in some deferral of interest (this last option is called the minimum payment). The monthly statement we send the borrower each month clearly defines each of these options.

Each year, we recompute the amount of the borrower's minimum payment. The new minimum payment is based on the then current interest rate, the current loan balance and the remaining term. For the first 10 years of the loan, we cap the borrower's payment increase each year at 7.5% above the prior year's payment.

This product, now generally referred to as an Option ARM, has been a great choice for consumers, as well as for World. And the reason is very simple: World has fair pricing, very careful underwriting and consumer-focused service before and after we originate each loan. We qualify the borrower at a payment amount that reflects the fully indexed interest rate, which is typically higher than the minimum payment, and helps to prevent borrowers from getting into loans they can't afford. Our overall default rate has always been extremely low, even taking into account the deep recession in Southern California in the early '90s, the implosion of the defense industry, high unemployment and declines in property values of up to 20%.

So now some background on ARMs and how we've been able to achieve these results. Late in the 1970s, it was already clear that portfolio lenders could not sustain the old model of financing long term, fixed rate loans with relatively short term consumer deposits and other funding vehicles then available. The thrift crisis was imminent, so we and other large savings and loan companies in California, including Home Savings, Great Western and American Savings, together with trade groups and others, studied the various forms of ARMs that were made elsewhere in the world. The research took us to Great Britain and other European countries where ARMs had been offered for many years. California's Legislature authorized "variable rate mortgages" (VRMs) at about that time, and while that was a significant departure from traditional fixed rate lending, we all concluded additional reforms were needed. VRMs provided only limited interest rate risk protection for lenders, yet often led to payment shock for borrowers.

At the end of the day, when we were deciding which type of ARM to offer, there were basically two choices: the Option ARM we chose, which insulates the borrower from payment shock via annual payment caps and the borrower's ability to defer interest, or what is called the "no neg" ARM, which does not allow deferred interest and is, therefore, more likely to result in payment shock for the borrower. Ultimately, in 1981, federal bank regulators authorized the forms of alternative mortgages now available in the market place. Congress followed in 1982 with legislation that allowed all lenders to offer these kinds of loans, in recognition of the difficulty some states were experiencing in authorizing them locally. The Option ARM has been almost our only product ever since, in California and all across the country.

Our experience proves the case for the Option ARM. Since 1981, we have funded over a million and a half Option ARM loans, totaling over \$250 billion, with an average loan size of about \$175,000. Significantly, our delinquency rates have always been well below industry averages, including the delinquency rates for institutions that offer only fixed rate loans. And we have never identified a single delinquent loan in our portfolio, much less a foreclosure or loss, which was due to the structure of our product. Let me emphasize that again. We have had no defaults due to the fact that our loans have adjustable rates and our borrowers have the option to pay less than the interest due. Our Option ARM, because it's designed, priced, underwritten and serviced responsibility, is successful by any measure.

We are also extremely focused on customer satisfaction and loyalty. World does not sell the servicing of its Option ARM product to other companies or forget about our customers the day we close their loan, which is an experience they may have with other lenders. We want customers for life. Let me give you a few examples of how we accomplish this.

Within the first month after a World Option ARM loan closes we call borrowers to welcome them as new customers and make sure that they have a firm understanding of their new loans. We emphasize the control that borrowers have with their loans, which we sometimes call TLC, for Total Loan Control. We then call customers at their yearly anniversary dates to make sure that their loans are still meeting their expectations.

I'd also like to note that, contrary to some reports, the Option ARM loan was never offered only to high-income, wealthy professionals. We and other California lenders have been offering the Option ARM since 1981 to the same full range of borrowers to whom we and others had always offered fixed rate mortgages. At World, because we don't sell our Option ARMs into the secondary market, we can utilize flexible underwriting as we evaluate loan applications. As a result, some of our loans might be considered "non-prime" by the standards of other lenders. While other lenders might increase the interest rate for such loans, we offer all our borrowers the same price for the same loan. In that sense, we don't offer "Alt A" or "subprime" loans. And as I mentioned, Option ARMs have worked well for both borrowers and World.

So what's been happening recently? Obviously, in the past few years, the Option ARM is being offered by a much wider spectrum of lenders, facilitated by the secondary mortgage market, technology developments, automated underwriting and credit scoring. While our version of the Option ARM has been around a long time, some of these new developments may not be fully tested, especially not in a soft real estate market. And some borrowers may be getting these products without being appropriately underwritten. I also want to stress that some of the products that have received the greatest criticism recently, such as 2/28s, do not allow deferred interest and, therefore, are more likely than our Option ARM to lead to borrower payment shock.

It may also be significant that even though many of our loans come to us via mortgage brokers, we conduct a careful review of each loan just as if the borrower came to us directly, to ensure the credit and property evaluations meet our standards. And while brokers are responsible for some initial product disclosures in such transactions, we follow up with written information prepared by World to ensure borrowers get a full and accurate description of the products they choose.

In addition, it often matters that we have been almost exclusively a "portfolio lender," that is, we keep the Option ARMs we originate rather than selling them into the secondary market. Why does that matter? As a portfolio lender, we care about our borrowers and how their loans perform. It's in our financial interest for our borrowers to be successful. When loans are sold to third party investors, the relationship between the lender and borrower is severed, and the company servicing the loan often has limited flexibility when a borrower does encounter financial difficulty. Even if the original lender decides it should help a particular borrower, it might not have funds necessary to buy back a loan it sold earlier or the capital its regulator might require it to hold to move such a loan back onto its own books. At World, we retain flexibility to work with our borrowers as necessary and appropriate.

Frankly, we're not here to defend all the practices in the market place. We have long supported a strong regulatory regime that encourages all lenders to provide full and fair disclosure to customers and prudently manage their business. And that includes avoiding lending practices that can be predatory or abusive, avoiding dilution of underwriting standards just to get volume, actively managing, monitoring and controlling risks of default, maintaining strong compliance and

risk management functions, and regularly and continually interacting with customers so that they understand what they have applied for, the loan received and how to best use their options responsibly. Of course, these sound practices really are relevant to any loan a lender may offer, and we certainly support the reemphasis of these principles in the new federal guidance published last year. We were gratified that that guidance reflects the practices that we've always employed, though even we have taken the opportunity to review our policies and consumer disclosure practices. We're doing a little fine-tuning, but in all material respects, we already complied.

As one side note, almost any other form of credit that people use to access home equity can result in some of the same risks to borrowers as products we're discussing, without some of the protections we offer. Any form of credit, including the more traditional types of loans such as equity loans on top of first lien loans, have not always been originated with careful underwriting and disclosures to borrowers. We focus on responsible origination in hopes of minimizing the risk of problems arising related to the borrower taking on too much debt.

We think the key policy concern for all of us in the mortgage business, including borrowers, lenders and regulators, should be the potential for borrowers to encounter payment shock. That has not been, and is unlikely to be, a consequence of well-designed and well-administered products such as ours.

Thanks for this opportunity to present our views. I'd be pleased to respond to your questions.

ORAL STATEMENT OF NEW CENTURY FINANCIAL CORPORATION

"Nontraditional Residential Mortgage Products"

At the California Senate Banking, Finance, and Insurance Committee

Michael Machado, Chair January 31, 2007 Mr. Chairman and Members of the Committee, my name is Marc Loewenthal, and I am Senior Vice President of Enterprise Risk Management and Chief Privacy Officer of New Century Financial Corporation.

I want to thank Chairman Machado for the opportunity to be here and commend the Committee for holding today's informational hearing so that it is better informed about nontraditional mortgage products and the nontraditional guidance as issued by the Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators.

At the Committee's pleasure, I'm prepared to discuss the written testimony which we have submitted for the Committee's review and to share New Century's perspective about the nontraditional guidance and its potential impact on the California mortgage market.

I would like to begin by taking a moment to introduce New Century for those who may not be familiar with us.

New Century is one of the largest mortgage lenders in the U.S. and in California. In 2006, we made over \$59 billion in loans, more than 30% of which were to Californians. Headquartered in Irvine, California, New Century originated loans across the country. We employ more than 7100 mortgage professionals, including more than 3,000 in California.

New Century was founded in 1995 on the principle that more Americans deserve an opportunity to achieve the dream of homeownership through access to affordable home loans – even those who do not fit the rigid lending criteria of conventional mortgage lenders. Today, we are fulfilling that mission and have grown into a company listed on the New York Stock Exchange that originates loans across the entire credit spectrum from prime to non-prime.

Our borrowers include individuals with excellent credit and those with limited or no credit history; the self-employed; and individuals who have blemished credit histories. Increasingly, our customers include people, who, because of the high price of real estate in California, need to use a higher proportion of their income to make their

mortgage payments. For all of those borrowers, nontraditional mortgage products offer them flexible ways to finance their homes while keeping them affordable. Non-traditional mortgages – principally interest-only loans – now make up about 20% of our business.

Nontraditional products are not new. In fact, non-amortizing mortgages were created prior to amortizing mortgages and 30-year fixed rate loans, which became popular after the creation of the Federal Housing Administration in 1934. Many were introduced more than two decades ago to compensate for high interest rates due to inflation and so that consumers could afford homes in high cost areas like California. Nontraditional mortgages include an array of products and features that allow consumers to defer principal and interest payments in order to tailor their mortgage payments to fit their specific life or family needs.

These products are not just provided by the private sector. Many non-profits, housing bond programs and even the Government Sponsored Enterprises – Fannie Mae and Freddie Mac – have recognized their importance in the marketplace and offer non-traditional products.

They are an extremely important loan financing option in California and other high cost markets located on the East and West coasts. Due to the high real estate appreciation in recent years in these markets, nontraditional loans may be the only viable option for families looking to start on the path to homeownership.

Nontraditional mortgages can also serve an important purpose for homeowners facing temporary financial stresses such as a divorce, loss of some income or other unexpected financial disruptions. The ability to refinance out of a fully-amortizing loan into a lower-cost nontraditional mortgage can buy a family time to reestablish their financial footing rather than face losing their home.

The widespread availability of nontraditional products has undeniably contributed to the nation's nearly record high homeownership rate, the significant increase in homeownership equity and wealth and a strong housing market.

All of these facts need to be kept in mind as California considers whether to adopt the guidance. Clearly, the guidance offers thoughtful recommendations on a number of important issues. For instance, it calls for better disclosures that are clear and understandable to the consumer.

However, we do have some concerns with the Guidance. First, we are concerned that overly rigid application of the prescriptive underwriting standards could limit access to proven, fair and affordable lending products that are critical in higher-cost markets like California. Second, we are concerned that the Guidance "hard-codes" underwriting standards in a way that inhibits lenders from employing market-driven risk management practices, including the ability to customize guidelines to address the needs and risks in a particular state or market. Finally, we are concerned with uneven application of the CSBS/AARMR Guidance both between federal and state regulators and among different state regulators.

We are concerned that if the Guidance is applied to mean that borrowers can only obtain a loan with a 10-year interest-only period if they can afford the fully-amortizing payment on their income today, then those products will only be available to the extremely wealthy to serve their cash management preferences. Our experience is that borrowers rely on 5 or 10-year interest-only periods precisely because they would struggle to afford the full payment on their incomes today. That is the whole point of why private sector lenders, Fannie Mae, Freddie Mac and other community-based lenders offer these products.

Moreover, rigid application of the Guidance may not only restrict important existing products from the marketplace, it also risks stifling the incentive for lenders to develop new and even better products to meet California's continuing affordability challenges.

Fewer and fewer Californians can afford a traditional 20% down, 30-year fixed, fully amortizing mortgage. Additionally, many markets in California are appreciating at a faster rate than income growth. More and more Californians will need new and innovative products such as nontraditional mortgages in order to afford a home.

Much has been said recently about applying the guidance to hybrid ARM products – 2/28, 3/27 products and the like. New Century adamantly opposes the inclusion of hybrid ARMs into the guidance. The history and features of hybrid ARMs do not warrant inclusion into the guidance and to do so would cause severe, negative consequences for consumers, the real estate market and the economy. We estimate that if these products are made subject to the guidance, it would affect 50% or more of the hybrid ARMs that are underwritten today, resulting in far fewer borrowers being able to qualify for the loan, thereby depressing the housing market further, cutting off homeownership to deserving families and significantly affecting the nation's economic health.

Hybrid ARMs are not a disaster waiting to happen. They offer borrowers the flexibility to purchase a home or refinance an existing mortgage to meet their personal financial needs. When underwritten correctly, they perform as well or better than other mortgage products and most borrowers are able to manage the monthly payments very well. Payment shock is far more muted in the vast majority of cases of ARMs compared to non-traditional mortgages, and as a result ARMs do not pose the same degree of risk to most borrowers when they reset. Each borrower's case is different. Their situation depends on what happens to interest rates, what happens to property values, what happens to the borrower's monthly income, expenses and credit, among other things, all of which can influence their ability to handle payments on reset. For these reasons, hybrid ARMs should not be included in the guidance.

Our analysis which is detailed in our written testimony shows that, by and large, the overwhelming majority of borrowers in our hybrid ARM loans experience significant credit improvement in the period from when their loan originated through the date of reset. These borrowers also experience, on average, both growth in equity and higher income during that 24-month period. In our experience, this leaves those borrowers in a position to obtain a lower-cost loan should they wish to refinance after the initial term of their loan.

We applaud the Senate Banking, Finance and Insurance Committee for its approach in considering this important issue. As the

Committee continues to consider how the guidance should apply in California, we urge the Committee to keep front of mind the positive historical record of nontraditional loans. As demonstrated over many years, nontraditional mortgages have been valuable instruments for new and current homeowners and their risks have been adequately managed throughout various economic and housing cycles.

Nontraditional products offer prospective and existing homeowners the ability to attain homeownership through affordable products, allow current homeowners to consolidate other financial obligations, help improve borrowers' credit impaired histories and build financial safety nets. These products perform well in the marketplace and are adequately managed by the primary and secondary mortgage markets.

We caution California policymakers to take a careful and deliberate approach to the guidance as they determine which elements make sense for California. Unlike other states, the guidance if adopted too strictly in California could further exacerbate the State's already serious affordability crises. Californians deserve a thorough and thoughtful analysis of the various elements of the guidance, rather than a hasty decision to adopt it without considering its potential impact.

Importantly, we also urge policymakers to refrain from including hybrid ARMs into the guidance. They are completely different products with different loan characteristics than nontraditional mortgages and have proven themselves to be beneficial products for many prospective and existing homeowners by providing flexible, affordable access to credit.

Thank you for the opportunity to address the Committee. I would be happy to answer any questions.



STATEMENT

Of

NEW CENTURY FINANCIAL CORPORATION

On

"Nontraditional Residential Mortgage Products"

At the California Senate Committee on Banking, Finance and Insurance

Michael Machado, Chair

January 31, 2007

Introduction

New Century Financial Corporation welcomes the opportunity to testify at the California Senate Banking, Finance and Insurance Committee's informational hearing on "Nontraditional Residential Mortgage Products." We appreciate the Committee's and Senator Machado's leadership in exploring the important issue of nontraditional mortgage products, their benefits to consumers, how they are offered by lenders, and if California should adopt the Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators (CSBS/AARMR) nontraditional Guidance.

New Century's testimony will address the nontraditional mortgage Guidance released by the five federal agencies and CSBS/AARMR¹ and the key question of

¹ On September 29,, 2006, the five federal banking agencies: Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of Thrift Supervision and the Board of Governors of the Federal Reserve System released its nontraditional mortgage guidance which applies to federally chartered depository institutions (the "Federal Guidance"). On November 14,

whether or not California should adopt some or all of the CSBS/AARMR recommendations. In so doing, we will share our views and experience on the benefits and performance of nontraditional mortgage products.

Further, although the Federal and CSBS/AARMR Guidance only cover non-amortizing products that allow for deferral of principal and/or interest (such as interest-only loans and payment option adjustable rate mortgages²), we will also share our serious concerns regarding suggestions to expand the guidance beyond these <u>nontraditional</u> products to also cover some types of traditional adjustable-rate mortgages.

About New Century

Founded in 1995, New Century Financial Corporation is a NYSE-traded real estate investment trust and one of the nation's largest and premier mortgage finance companies, providing loans to borrowers nationwide through its operating subsidiaries, New Century Mortgage Corporation and Home123 Corporation. The Company offers a broad range of mortgage products designed to meet the needs of all borrowers and is committed to serving the communities in which it operates with fair and responsible lending practices. We originate loans through our sales offices, regional processing centers and our network of independent mortgage brokers and correspondent lenders located across the country. We employ more than 7,100 associates nationwide, 3,000 of which are in California.

In 2006, New Century originated \$59.8 billion in prime, non-prime and Alt-A mortgages. We originated \$50.7 billion through our New Century Mortgage wholesale channel and \$9.1 billion through our Home123 retail channel. We offer a variety of different products to meet consumer needs and preferences, including-fully amortizing fixed-rate and adjustable-rate mortgages.

New Century Mortgage Loan Originations by Channel and Type

2006			(in billions)
	Wholesale	Retail	Total
Non-Prime	\$47.5	\$4.1	\$51.6
Prime and Alt-A	\$3.2	\$5.0	\$8.2
Total	\$50.7	\$9.1	\$59.8

- Through the 3rd quarter 2006, we originated \$25.4 billion in purchase money loans and \$20 billion in refinances.³
 - o \$13.9 billion in fixed rate loans.
 - o \$31.5 billion in ARM loans.

2006, CSBS/AARMR released its nontraditional guidance for state-licensed entities (the "CSBS/AARMR Guidance").

² Hereafter sometimes refered to as I/Os and payment option ARMs.

³ As of the date of this testimony, New Century had yet publicly released its detailed 2006 4th quarter performance data.

- As a subset of these loan amounts we originated:
 - o \$1.1 billion in fixed-rate interest-only loans.
 - o \$6.6 billion in interest-only ARM loans.
 - Less than 1% of our origination volume was payment option ARMs, all of which were originated to higher-credit, lower-risk customers.
- Our average loan size in California is \$238,000; nationwide it is \$185,000.
- Approximately 30% of our loans are originated in California.
- At the close of 2006, New Century had 34 regional processing centers and 262 sales offices (retail branches). Of those, 7 regional processing centers and 44 sales offices are in California.
- We have an extensive network of thousands of approved mortgage brokers through which we fund approximately 85% of our mortgage loans.

Although we offer products to individuals in both the prime and non-prime markets, our Company's specialty is providing non-prime borrowers with affordable lending products. Typically, non-prime borrowers do not satisfy the stricter credit, documentation or other underwriting standards prescribed by the Government Sponsored Enterprises (GSEs). Because these loans present a higher risk of default, we charge rates that are slightly higher than the rates offered by lenders servicing prime borrowers who have credit and loan characteristics that present lower risks. Non-prime borrowers are individuals who may need more of their income to cover their housing cost, or may not have enough savings for an adequate downpayment. Some of these borrowers may also have impaired credit or have irregular income due to commission-based employment or from being self-employed. These characteristics typically disqualify a borrower from the prime market.

In addition to specializing in the non-prime market and offering prime products, New Century, through its Home123 subsidiary offers Federal Housing Administration and Veterans Administration loans. Further, New Century originates loans through, and works in conjunction with, a number of California specific housing agencies and programs such as the California Housing Finance Agency (CalHFA), California Housing Downpayment Assistance Program, California Public Retirement System (CalPERS and CalSTRS) as well as the National Homebuyers Fund's Access and FirstHouse Bond programs. These agencies and programs assist eligible individuals and families with obtaining homeownership (many of them new homeowners), specialized mortgage products and downpayment assistance.

Federal and State Nontraditional Guidance

Historically, the mortgage finance industry has been quite effective at designing mortgage options to address consumer needs and preferences. In recent years, with housing affordability presenting acute challenges in many parts of the country, mortgage lenders have offered a wide range of more flexible and affordable mortgage options, including so-called nontraditional mortgages.

Although these products had been in the marketplace in one form or another for decades, in the past few years they have grown to represent a more substantial portion of

the mortgage market. They have also been offered to a broader range of consumers, including those with higher risk features such as self-employment, higher debt ratios and smaller down payments.

As a result of the growth and expansion of nontraditional products, federal regulators sought to evaluate their potential impact on depositories' safety and soundness and on consumer interests.

Federal regulators in particular were concerned with federally-chartered banking institutions offering nontraditional mortgages combined with higher-risk features such as low-documentation or simultaneous second lien loans. Regulators feared that these loan characteristics presented unique risks for banks that should be appropriately managed. Further, regulators expressed concern that some borrowers did not adequately understand their nontraditional loans, thus putting their financial well being in jeopardy.

As a result, the five federal banking agencies – after an extensive public comment period in which mortgage lenders and industry trade organizations participated – collectively published final Guidance in the *Federal Register* (Volume 71, Number 192, Page 58609-58618) on nontraditional mortgage product risks. The Federal Guidance applies to all banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

The Federal Guidance focuses on three areas:

- Loan Terms and Underwriting Institutions should ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of the borrower's repayment capacity at "the fully indexed rate assuming a fully amortizing payment including potential for negative amortization amounts."
- Portfolio and Risk Management Practices Institutions should have established, strong risk management standards to assess and manage the risks associated with nontraditional mortgage loan products in addition to appropriate capital levels and allowances for loan and lease losses.
- Consumer Protection and Disclosure Issues Institutions should ensure that their communications to consumers have sufficient information so that consumers can clearly understand loan terms and associated risks such as "payment shock" and negative amortization prior to making a product choice.

Recognizing that the Federal Guidance did not cover the lending operations of many non-bank lenders, on November 14, 2006, CSBS/AARMR distributed their parallel Guidance to state agencies that regulate residential mortgage brokers and non-bank

lenders. The purpose of the CSBS/AARMR Guidance is to promote consistent regulation of the mortgage market and to clarify how providers can offer nontraditional mortgage products in a way that clearly discloses the risks that borrowers may assume. CSBS/AARMR encouraged the state regulatory agencies to adopt the Guidance and issue it for use by their regulated entities. Since CSBS/AARMR distributed their Guidance, 24 states have announced their adoption of the recommendations (as regulation, guidance or best practice) or their intention to hold hearings with that result in mind. 5

Although the CSBS/AARMR Guidance substantially mirrors portions of the Federal Guidance, it deleted those provisions of the Federal Guidance that pertained to depository institutions, such as portfolio management as it related to capital requirements, references to prior federal guidance on related topics, repurchase requirements constituting recourse, portfolio concentrations, and so forth.

Nontraditional Products and Their Benefits

Nontraditional products are not new. In fact, non-amortizing mortgages were created prior to amortizing mortgages and 30-year fixed rate loans, which became popular after the creation of the Federal Housing Administration in 1934. Many were introduced more than two decades ago to compensate for high interest rates due to inflation and so that consumers could afford homes in high cost areas like California. Nontraditional mortgages include an array of products and features that allow consumers to defer principal and interest payments in order to tailor their mortgage payments to fit their specific life or family needs.

In contrast to traditional mortgages, nontraditional mortgages are not fully amortizing. The products include fixed-rate loans as well as adjustable-rate mortgages with features such as interest-only payments or the ability of consumers to choose different payment options. The latter type of loan, a payment option ARM, generally allows borrowers to choose from a payment predicated on: a 30 year fixed-rate fully amortizing loan that includes principal and interest, an interest-only payment that is not amortizing, a 15 year fixed-rate loan or one that results in some degree of negative amortization.

Nontraditional products are not just provided by the private sector. Many non-profits, housing bond programs and even the GSEs – Fannie Mae and Freddie Mac – have recognized their importance in the marketplace and offer non-traditional products.

⁴ New Century is regulated by state agencies in the states in which we operate. In California, we are regulated by the Department of Corporations and the Department of Real Estate.

⁵ States indicating that they have adopted or intend to adopt the CSBS/AARMR recommendations as either best practices, guidance or regulations are: Arizona, Connecticut, District of Columbia, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, New Hampshire, North Carolina, North Dakota, Ohio, South Dakota, Texas Vermont, Washington and Wyoming.

⁶ See page 3 of the Mortgage Bankers Association's March 29, 2006 comments to federal agencies on "Proposed Interagency Guidance on Nontraditional Products," http://www.ots.treas.gov/docs/9/962331.pdf.

Nontraditional mortgage products are an extremely important loan financing option in California and other high-cost markets located on the East and West coasts. Due to the high real estate appreciation in recent years in these markets, nontraditional loans are oftentimes the only viable option for families looking to start on the path to homeownership.

Additionally, nontraditional mortgages allow for greater flexibility on the part of the borrower or family to manage their finances in order to meet their obligations and fulfill their aspirations. For instance, many borrowers who have seen their homes appreciate over the years have opted to use the equity in their home to consolidate their debt obligations, pay for home improvements that further increased the value of their property, or to pay for educational, health and other expenses.

Nontraditional mortgages can also serve an important purpose for homeowners facing temporary financial stresses such as a divorce, loss of some income or other unexpected financial disruptions. The ability to refinance out of a fully-amortizing loan into a lower-cost nontraditional mortgage can buy a family time to reestablish their financial footing rather than face losing their home.

The widespread availability of nontraditional products has undeniably contributed to the nation's nearly record high homeownership rate, the significant increase in homeownership equity and wealth and a strong housing market. According to the Mortgage Bankers Association, homeownership rates for the nation and for specific minority communities are all at or near their highest levels, and from the Federal Reserve's Flow of Funds data, residential real estate assets owned by households has increased from \$10.3 trillion in 1999 to \$20.4 trillion in the first quarter of 2006 and aggregate homeowners' equity now exceeds \$10 trillion. ⁷

New Century's Views on the Guidance

New Century believes that the CSBS/AARMR Guidance offers thoughtful recommendations on a number of important issues. For instance, it calls for better disclosures that are clear and understandable to the consumer. It is in the best interests to all parties involved in the mortgage transaction (borrower, lender and investor) that the consumer fully understands the product he or she is obtaining. While lenders like New Century are continuously developing enhanced consumer disclosures, the CSBS/AARMR Guidance contains some innovative recommendations that will benefit consumers and lenders alike.

In addition, the CSBS/AARMR Guidance provides helpful recommendations regarding how lenders should approach layered risk in non-traditional mortgage products, when those products are combined with other higher-risk features.

⁷ Mortgage Bankers Association Testimony, "Calculated Risk: Assessing Non-traditional Mortgage Products" before a Joint Hearing of the Subcommittee on Housing and Transportation and Subcommittee on Economic Policy of the U.S. Senate Committee on Banking, Housing and Urban Affairs; September 20, 2006; http://banking.senate.gov/files/broeksmit.pdf.

However, we do have some concerns with the Guidance. First, we are concerned that overly rigid application of the prescriptive underwriting standards could limit access to proven, fair and affordable lending products that are critical in higher-cost markets like California. Second, we are concerned that the Guidance "hard-codes" underwriting standards in a way that precludes lenders from employing market-driven risk management practices, including the ability to customize guidelines to address the needs and risks in a particular state or market. Finally, we are concerned with uneven application of the CSBS/AARMR Guidance both between federal and state regulators and among different state regulators.

We believe these factors weigh in favor of a carefully considered, deliberate and nuanced approach for California rather than unquestioning adherence to every single element of the CSBS/AARMR Guidance without evaluating its appropriateness for California.

Overly Prescriptive Underwriting Standards

We are concerned that the Guidance's prescriptive underwriting standards, if rigidly applied, risk eliminating access to tried and proven, affordable and fair mortgage products. For example, the Guidance calls for lenders underwriting nontraditional mortgage products to consider the fully-indexed, fully-amortizing payment. However, the Guidance does not expressly allow for the presumption of borrower income growth in order to qualify for the mortgage. In our experience, borrowers select loans with 5 or 10-year interest-only periods with the reasonable expectation that they will have some income growth over that period. They may also expect a reduction in other debts and expenses (e.g. car payments, tuition) over that period.

If the Guidance is applied to mean that borrowers can only obtain a loan with a 10-year interest-only period if they can afford the fully-amortizing payment on their income today, then those products will only be available to the extremely wealthy to serve their cash management preferences. Our experience is that borrowers rely on 5 or 10-year interest-only periods precisely because they would struggle to afford the full payment on their incomes today. That is the whole point of why private sector lenders, Fannie Mae, Freddie Mac and other community-based lenders offer these products.

Moreover, rigid application of the Guidance may not only restrict important existing products from the marketplace, it also risks stifling the incentive for lenders to develop new and even better products to meet California's continuing affordability challenges.

Limiting Lenders' Ability to Respond and Adapt to Changing Markets

Mortgage lenders respond not only to consumer demand for products and services but also to their own risk management analysis of how those products will perform in their portfolio. They also focus on how secondary market investors and the ratings agencies will evaluate and pay up or pay down for loans with particular risk

characteristics. As a result, the mortgage market has a great ability to correct itself. For instance, a lender originating too many risky mortgages will find itself at a pricing disadvantage in the mortgage market. These changes in the market place occur at a much faster rate than through regulatory initiatives and ultimately better protect borrowers and the mortgage market. In fact, even without the Guidance, the mortgage market is clearly in a cycle of tightening now due to the weaker housing market and higher interest rates.

However, just as there are times to tighten, it is appropriate to note that there are also times where prudent risk-management permits relaxation of certain guidelines or standards because of other compensating environmental factors.

We are concerned that the Guidance will have the effect of "hard-coding" underwriting standards into a regulatory framework. That could restrict lenders from making thoughtful, pragmatic and timely risk-management decisions either nationally or on a regional basis.

For example, today most lenders have much tighter underwriting guidelines and higher risk-based pricing in industrial states like Michigan, Ohio and Indiana because of the weaker employment and wage environment and housing market. By prescribing the same key common standards in every market, we are concerned that the Guidance may restrict the ability for lenders to make well-informed, analytically sound risk distinctions in different states and regions.

Uneven Application of Guidance

Although federally-regulated banks and thrifts have a long history of receiving various forms of official "guidance" from their supervisory regulators, this is not an established practice among state-chartered non-depository lending institutions that receive regulation in the form of expressly adopted laws and regulations. We believe this lack of familiarity or precedent will result in considerable inconsistency and confusion in how different state regulators apply the CSBS/AARMR Guidance.

We expect federal regulators will apply the Federal Guidance in a considered and deliberate way, consistent with their experience applying other forms of published guidance. They are well accustomed to risk-based, analytical approaches focused on the safety and soundness of their regulated institutions. They also had the benefit of a nearly year-long process of notice, comment, consideration and deliberation prior to their releasing the Federal Guidance in the fall of 2006.

We are concerned, however, that some of the states that have adopted the Guidance may unintentionally take a more rigid approach. This is not to impugn the competence or thoroughness of the state regulators. (We have been through over 150 examinations over the years by our various state regulators and we can attest first-hand to their thoroughness and professionalism.) Rather, it is based on a recognition that their activities are more heavily driven by express, objective laws and regulations (for example, does an institution have the proper license or the required legal forms, and if

they charge impermissible fees, etc.) Moreover, many of the states that adopted the CSBS/AARMR Guidance did so without hearings, notice or the normal deliberative process that would typically accompany state lending regulation.

We worry that the inevitable result will be that instead of uniformity, there will be confusion as federally chartered institutions live by one set of rules and state-chartered institutions live by another. There will also be neighboring states that will apply the identical language in drastically different ways, creating confusion for consumers and for lenders who often operate out of regional centers serving multiple states.

Should California Adopt the CSBS/AARMR Model?

Since the CSBS/AARMR released its recommendations that all 50 states should adopt the guidance, 24 states have done so. New Century believes that the remaining states, especially California, should be careful when considering adoption. Sections of the Guidance contain important consumer protections and provide suggestions for better disclosures to consumers of the loan products that the lender is offering. New Century intends voluntarily to adopt many of these aspects of the Guidance nationwide as part of its practices and procedures.

However, with regard to the portions of the Guidance that deal with underwriting; we are urging that California and other states consider a deliberate, cautious, incremental approach so as not to disrupt the mortgage and housing market.

While nontraditional products have a much more limited presence in lower cost states like Iowa and Indiana, they are a critical feature of the California mortgage and housing market. ⁸ Californians deserve careful consideration of all aspects of the CSBS/AARMR Guidance rather than a hasty decision to adopt every single element of the Guidance.

Fortunately, California has the flexibility to take this more deliberative approach. Its existing laws and regulatory framework already provide the Department of Corporations and the Department of Real Estate considerable authority to review the lending practices of regulated entities. In addition, laws such as AB 489 apply only to state-chartered lenders and provide significant additional restrictions and controls that don't apply to federally-chartered banks and thrifts. California already has elevated legal protections and regulatory authority over state-chartered lending institutions, so it can take the time necessary for a thorough and fact-based approach to evaluating what, if any, elements of the CSBS/AARMR Guidance to adopt.

⁸ California, in particular, needs to preserve a vibrant market in flexible products that address the huge housing affordability challenges. California's median home price as of November 2006 was \$555,290 – on of the most expensive states in which to own a home. (California Association of Realtors, California Association of Realtors, http://www.car.org/index.php?id=MzE3ODY.) Additionally, according to the California Association of Realtors' affordability index, which measures the percentage of first time homebuyers that can afford to purchase a median priced home in the state, the percentage of families able to buy a home fell to 24% in the 3rd quarter of 2006 compared to 28% in the 3rd quarter of 2005. (California Association of Realtors, http://www.car.org/index.php?id=MzY3OTE).

New Century Opposes Extension of Guidance to Hybrid ARMs

Currently, the Federal and CSBS/AARMR Guidance apply to non-amortizing products that allow for the deferral of interest and principal. Other ARM products such as hybrid ARMs are not affected. However, it has come to New Century's attention that some federal regulators, advocacy groups and six US Senators specifically called for the inclusion of hybrid ARMs into both the Federal and CSBS/AARMR Guidance.

Hybrid ARMs are a variation of ARMs in that they have a fixed interest rate for a period of time (usually 2 or 3-years, although some can be fixed for 5, 7 or 10-years) and then the rate adjusts (usually every 6 months or 1-year) to reflect market rates after the fixed period. For example, a 2/28 hybrid ARM would have a fixed rate for the first two years and then would have an adjustable rate for the remaining 28-years. Hybrid ARMs usually have a cap on the amount the interest rate can increase at a given time. Importantly, the hybrid ARM is a *fully amortizing* loan. The advocacy groups claim that hybrid ARMs, what they refer to as "2/28 exploding ARMs," are responsible for causing "payment shock" for borrowers after the initial fixed-rate period. However, our data significantly contradicts these assertions.

New Century adamantly opposes the inclusion of hybrid ARMs into the Guidance. We believe that the history and features of hybrid ARMs do not warrant inclusion into the guidance and to do so would cause severe, negative consequences for consumers, the real estate market and the economy. We estimate that if these products are made subject to the Guidance, it would affect 50% or more of the hybrid ARMs that are underwritten today, resulting in far fewer borrowers being able to qualify for the loan, thereby depressing the housing market further, cutting off homeownership to deserving families and significantly affecting the nation's economic health.

The major mortgage industry associations, namely the Mortgage Bankers Association, the American Financial Services Association, and the Financial Services Roundtable have all taken the position that hybrid ARMs were never intended to be incorporated into the Guidance as they are fully-amortizing loans with different features and characteristics than non-amortizing, interest-only and payment option loans.

Hybrid ARMs have over a 10-year track record of serving the needs of borrowers and have been the most popular and widely used type of non-prime loan. They have performed well during a variety of interest rate and economic cycles. They are a well established product with tried and tested underwriting guidelines, risk management practices and consumer disclosures. To our knowledge, their design and widespread use

⁹ See Michael Calhoun, President of the Center for Responsible Lending, testimony before a Joint Hearing of the Subcommittee on Housing and Transportation and Subcommittee on Economic Policy of the U.S. Senate Committee on Banking, Housing and Urban Affairs; September 20, 2006; http://www.responsiblelending.org/pdfs/Testimony-Calhoun092006.pdf

¹⁰ On December 7, 2006, US Senators Paul Sarbanes (D-MD, retired), Christopher Dodd (D-CT), Charles Schumer (D-NY), Jack Reed (D-RI), Wayne Allard (R-CO) and Jim Bunning (R-KY) sent a letter to the five federal banking agencies and to CSBS encouraging the extension of the Federal Guidance to hybrid ARMs, specifically to 2/28 mortgages.

has never, until now, given rise to regulatory or consumer protection concerns, despite being reviewed in the examination process by every federal and state regulator of mortgage lending institutions.

Hybrid ARM Advantages

Hybrid ARMs have many advantages. They offer a significantly lower monthly payment for the fixed period than an equivalent fixed-rate loan. The rate difference is generally at least 70 or 80 basis points. Given this difference, a borrower who selects a 2/28 hybrid ARM has usually paid less cumulatively until month 36 or beyond. For borrowers who are particularly concerned about the payment obligation for the first year or two of the loan, these programs present an attractive choice.

Hybrid ARMs structure is well suited to for prime borrowers as well as non-prime borrowers looking for a transitional product as they reestablish their credit and financial footing. Many non-prime borrowers are looking for a loan to allow them to get back on track in terms of their payments and other financial situation over that initial period, and then have the prospect of refinancing and qualifying for a lower-rate prime loan. This is reflected in the relatively short average life of most hybrid ARM loans (approximately 2.5 years) compared to the longer average life of fixed-rate loans (approximately 5-years).

Hybrid ARMs are also well suited to borrowers who anticipate increases in income or reduction in expenses over the initial 2 or 3-year period of the loan. In many cases, in addition to enhancing their credit profile over the 2 or 3-year period, the borrower also has the prospect of improvements to their income or reductions to their expenses, which help them to migrate up the credit spectrum when they eventually refinance. Borrowers often select a mortgage product based in part on their expectations of their other monthly expenses over what they anticipate will be the life of their loan. For example, if tuition payments, school loan payments, car loan payment or home improvements expenses have the prospect of going down or going away over the coming two or three years, a borrower may improve their financial position by selecting a mortgage product that has lower payments during the initial period. Likewise, even with modest annual raises, we find that hybrid ARM borrowers are well able to absorb the eventual increases in their monthly payments.

Hybrid ARMs can help borrowers achieve homeownership and begin to build equity. In California and other high-cost markets where hybrid ARMs are particularly popular, they oftentimes represent one of the only ways for consumers to achieve homeownership and begin building equity. Borrowers two, three, or four years ago who chose hybrid ARMs in those markets have, by and large, benefited from substantial increases in their home values. Had they waited to be able to afford a fixed-rate program, many of them would never have attained homeownership or built wealth. It is not an overstatement to say that a significant portion of the growth in homeownership rate in the 10-years is due to nontraditional mortgages and especially hybrid ARMs.

Performance History and "Payment Shock"

Regarding payment shock, the design and performance history of hybrid ARMs demonstrates that, by and large, borrowers are able to address the more modest potential payment increases in those products.

The long history of hybrid ARMs demonstrates that payment increases are not inevitable. It depends both on the initial structure of the hybrid ARM and what happens to interest rates during the 2 or 3-year fixed period for the loan. For example, if a customer elected to take a 2/28 hybrid ARM 4-years ago, they experienced little or no payment increase when the initial adjustment period was over because interest rates went down. In contrast, if a customer elected to take the same product 2-years ago, they would be facing the prospect of their payment increasing today. Even if rates remain flat, the built-in difference between the start payment and fully-indexed payments for hybrid ARMs today is on average nowhere near the 40-50% difference claimed by some advocacy groups.

Most lenders try to keep the payments affordable and competitive during the time that the initial start rate is in effect and the time that the fully adjusted rate goes into effect. Today, there is generally no more than a 2-3% difference between the average start rate and the average fully-indexed rate. And historically, over the past 10-years that difference has generally been quite a bit less.

Contrary to what is represented by many advocacy groups, hybrid ARMs are structured so that there is a cap on the periodic adjustment, even if interest rates have gone up. This mutes the payment shock and makes it more gradual. In many cases, the initial adjustment is capped at 1.5 or 2% for periods of 6 months to 1-year. Consequently, payments increase gradually rather than suddenly.

Many lenders already fine-tune their underwriting guidelines for higher-risk borrowers to mitigate the potential for payment shock. However, they take a more nuanced and surgical approach to this, rather than the sweeping and overbroad approach that would result if the guidance were applied across the board to hybrid ARMs.

Meaningful Disclosures

Lenders already use some tried and true, well established methods to assist borrowers in understanding hybrid ARM products that can help mitigate any risks associated with them. They include:

Providing the required ARM disclosures including the Federal Reserve's helpful
and informative "Consumer Handbook on Adjustable Rate Mortgages." The
handbook covers issues like "payment shock" and explains the advantages and
disadvantages of ARM programs.

- Many lenders supplement the required disclosures with additional consumerfriendly material describing the product features. Some also provide borrowers with an 800 number to contact a HUD approved counselor if they feel they need one to sort through product choices.
- Lenders who have retained servicing portfolios are able to monitor those borrowers who are facing particularly large payment shocks. Many lenders now have programs to offer borrowers low-cost refinance opportunities into other products that might mitigate the payment shock – such as a 40-year and 50-year fixed-rate loan product.

Hybrid ARMs are not a disaster waiting to happen. They offer borrowers the flexibility to purchase a home or refinance an existing mortgage to meet their personal financial needs. When underwritten correctly, they perform as well or better than other mortgage products and most borrowers are able to manage the monthly payments very well. "Payment shock" does not occur in the vast majority of cases and ARMs do not pose significant risks to most borrowers when they reset. Each borrower's case is different. Their situation depends on what happens to interest rates, property values, the borrower's monthly income, expenses and credit, among other things, all of which can influence their ability to handle payments on reset. For these reasons, hybrid ARMs should not be included in the Guidance.

New Century Experience with Hybrid ARMs

Improved Credit Profiles

One advantage of hybrid ARMs is that they have proven themselves to be an effective way for borrowers to improve their credit profile and financial circumstances. This enables borrowers to eventually elect a lower-cost refinance mortgage option should they wish to do so. For most mortgage lenders, one primary determinant of creditworthiness is mortgage or rental-payment history. That is why on mortgage rate sheets, there may be a very broad range of FICO scores within a particular credit grade, but mortgage history is a more fixed determinant and predictor of creditworthiness across all credit grades.

We looked at borrowers who obtained 2/28 loans from us in 2004 and for which we serviced the loans, thereby having visibility into loan performance from inception. Those loans all had scheduled resets in 2006, so we were able to observe their performance through the reset date.

We stratified those loans into credit grades. Here is a sampling of what we found:

We made and had permanent servicing on 1,671 loans in 2004 that were in our A-minus credit grade and that had experienced at least one 30-day late payment on their mortgage or their rental payment in the 12-months prior to our loan. We then tracked the performance of those loans through their reset date at month 24.

We found that 78.3% of them had not experienced a single late payment in the two years following origination of their 2/28 hybrid ARM.

- In fact, when we look at all of the 2/28 loans that we originated and continued to service from 2004 that had 1 or more 30-day late payments, we generally found that between 75% and 87.7% (depending on credit grade) experienced no 30-day late payments in the succeeding 24-months. This is a population of several thousand loans that is representative of our overall mix of production in those credit grades.
- Similarly, when we look at our lower credit-grade borrowers from 2004 those who had experienced one or more 60-day late payments on their mortgage or rent in the prior 12 months -- we find that over 84% of them did not have another 60-day late payment in the succeeding 24-months.
- We also observed that the combined loan-to-value ratio (CLTV) was reduced through amortization and home price appreciation. On average, our 2/28 loans from 2004 had CLTVs of 84.9%. By tracking home price appreciation by Metropolitan Statistical Area, and by tracking the scheduled amortization of the principal of those loans in the 24-months following origination, we estimate that on average our 2004 2/28 loans had CLTVs of 65.1% by the time of their reset. (Note: we also ran the CLTVs assuming other rates of appreciation. At 10% cumulative appreciation over 2-years the CLTV would have been 75.7%, at 5% over 2-years the CLTV would have been 79.3% and if all loans had experienced no appreciation at all, the CLTV would have been 83.2%. This illustrates the effect of amortization on improving CLTV.)
- The average debt-to-income ratio on our 2/28s originated in 2004 was 40.7%. Federal economic data from the Bureau of Labor Statistics shows that wages and salaries have increased approximately 2.6% per year since 2004. We don't have any reason to believe the income increases of our borrowing pool would differ significantly from the population at large. Based on this, the average debt-to-income ratio of these borrowers would have declined to 38.6% in the succeeding two years after we originated their loan. (This assumes that none of the loans paid off prior to reset. Also, this is based on the original payments at origination not the new payment at reset.)
- When we track similar data from 2003 loans from their origination through 12/31/06 or through their earlier refinance, we find that the results are similar.
- Conclusion: Our analysis shows that, by and large, the overwhelming majority of borrowers in our hybrid ARM loans (generally between 75% and 80%) experience significant credit improvement in the period from when their loan originated through the date of reset. (This does not mean the rest experience credit deterioration; it might just stay the same). These borrowers also experience, on average, both growth in equity and higher income during that 24-month period.

In our experience, this leaves the large majority of those borrowers in a position to receive a lower-cost loan should they wish to refinance after their reset.

Favorable Refinance Experience

We analyzed a sample of loans that we originated and serviced both nationwide and in California for the years 2003 through 2006 to review what happened to them at the time that their loans reset from the original term. Here is what we learned with regard to our ARM and interest-only loans:

Nationwide – 70% refinanced before or at the time of reset. In California – 85% refinanced by that time, which is indicative of the price appreciation and the decrease in CLTV's that has occurred in California.

The overwhelming majority of these refinances were with lenders other than New Century, since for most of that period our product mix consisted exclusively of non-prime loans and we did not have a program of actively re-soliciting our customers for new loans. As a result, we do not have great visibility into the rates and terms of the loans obtained by customers who refinanced with third parties. Anecdotally, however, we believe that a significant percentage of those customers refinanced into prime and Alt-A loans, many with fixed rates.

However, we do have quite a bit of visibility into a subset of approximately 5,000 loans where the borrower refinanced with New Century. This is not necessarily a representative sampling, since many borrowers would have migrated up the credit spectrum where New Century's product offerings were not as competitive and likely refinanced with other lenders.

Of this subset, we found the following:

- The average credit scores improved from the time of origination until the date that the loans refinanced.
 - Nationwide the average credit score rose from 596 to 615.
 - California the average credit score rose from 606 to 621.
- Risk grades improved as shown in the tables below:

Nationwide	Original Loan	Refi Loan
AA to A+	71.26%	84.99%
A- and Below	28.74%	15.01%

California	Original Loan	Refi Loan	
AA to A+	75.07%	84.92%	
A- and Below	24.93%	15.08%	

- Average CLTVs decreased on the new loans both nationwide and in California, notwithstanding the fact that some of the refinances were cash-out refinances or 80/20 combination loans.
- Of the loans that refinanced, there was significant migration to fixed-rate loans;
 - Nationwide 30% refinanced into a fixed rate loan; the others refinanced into another hybrid ARM or a 5-year interest only product.
 - <u>California</u> 24% refinanced into a fixed rate loan; the others refinanced into another hybrid ARM or a 5-year interest only product.

The above data confirm that hybrid ARMs serve as a stepping stone for many borrowers, who then experience migration up the credit grade and FICO spectrum, thereby having access to a broader array of products.

Delinquencies and Foreclosures

When we looked at delinquency and foreclosure rates for sub-prime loans generally, we observed that (i) delinquencies and foreclosures on hybrid-ARMs are not nearly as high as the consumer advocates contend, (ii) while as expected, delinquencies and foreclosures on hybrid ARMs are higher than on fixed-rate loans, the differences are not that significant and (iii) California has been faring better than the rest of the country over the past few years.

- 60+ delinquencies for the 3rd quarter 2006 as reported by the Mortgage Bankers Association¹¹ for all sub-prime loans was 9.59%.
- The MBA's foreclosure rate for the same period for all sub-prime loans was reported at 3.86% 12.
- 60+ delinquencies for California sub-prime loans for the 3rd quarter was 9.12%.
- The foreclosure rate for the same period for California sub-prime loans was 3.32%

New Century's data compared favorably to industry published data through the 3rd quarter 2006.

- Our delinquencies were less than the MBA's published delinquencies for each of our California vintages (7% for 2003; 5.5% for 2004; 5.8% for 2005; and 8.7% for 2006).
- Our foreclosure rates for the same period for California and non-California loans were 1.5%-2% higher than the MBA's data for our 2006 vintage loans.

¹¹ Third Quarter 2006 National Delinquency Survey from the Mortgage Bankers Association

This does not mean that all these loans are foreclosed. As subset of these loans will cure or go through loss mitigation in order to avoid foreclosure.

Foreclosure rates for our California loans in the 2003, 2004, and 2005 vintages were lower than the MBA's published rate by as much as 1% for our 2004 vintage and slightly less or comparable for the other vintages.

• The delinquency and foreclosure rates for our fixed-rate mortgages is less than those for hybrid ARMs and interest only loans. This is to be expected because ARMs are considered riskier than fixed-rate mortgage products. 13

Types of Nontraditional and Hybrid ARMs New Century Offers

The following is a sampling of some of the first mortgage products, including nontraditional and hybrid ARM products, that we offer:

- 2 and 3-year ARM products having maturities of 30, 40, and 50-years.
- 30, 40, and 50-year fixed-rate products.
- 5 and 10-year interest rate products.
- Conventional fixed-rate prime loans with 10, 15, 20, 25 and 30-year terms.
- 15 and 30-year fixed-rate prime loans.
- 10-year interest-only prime loans.
- FHLMC A Minus loans.
- 3/1, 5/1, 7/1, and 10/1 prime interest-only loans.
- Payment option mortgages.

Enhanced Disclosures for ARM Products

We stated previously that we recognize it is important for borrowers to understand the features of their hybrid ARM or nontraditional loan. To that end, we take a variety of steps to facilitate this, including:

- Providing borrowers a disclosure that explains how their interest rate and
 payment are determined, how the interest rate can change and how the
 payment can change (see Appendix 1 attached for a sample form) this
 disclosure is sent to the consumer with their initial disclosure package and
 with any re-disclosure and with the closing documents package;
- Providing borrowers a copy of the Federal Reserve "Consumer Handbook on Adjustable Rate Mortgages" which covers the potential risks and issues associated with ARMs;

¹³ Over 90% of the loans originated by New Century have FICO scores greater than 600. With regard to these loans (i) California fixed rate loans perform better than those originated outside California; (ii) 60+ delinquencies for California fixed-rate loans originated in the 2003 and 2005 vintages are less than 1% and less than 2% for the 2004 and 2006 vintages. Foreclosure rates for California fixed-rate loans in all of these vintages are less than 1%.

 Providing borrowers the HUD "800" number so that they can obtain a HUD-approved counselor to advise them in the loan process if they feel it is necessary.

Our policy with our loan officers and with respect to our brokers is that they need to explain the key terms of a loan to the customer.

Underwrite Based on Ability to Repay

We always consider repayment ability when underwriting any loan. When we are qualifying borrowers for a loan, we take into account their real estate tax and home insurance payments, homeownership association dues, recurring payments, and any revolving or installment debt. All of our interest-only products offer 5, 7 or 10-year interest-only terms so that the borrower has additional time to increase their income, allow for home price appreciation, and provide flexibility to refinance before the amortization period begins.

Consistent with sound business practices, we are always reevaluating our underwriting criteria and making the adjustments we think are prudent and appropriate. In the past year, the trend has been toward tightening those guidelines and standards. For example, we recently made the following changes to our underwriting criteria:

- Tightened our first time homebuyer criteria.
- Tightened the criteria for stated wage earner transactions that have a LTV/CLTV greater than or equal to 90%.
- Qualify "at risk borrowers" (less than 580 credit score and LTV greater than 80%) for ARM loans at fully-indexed interest rate less 100 basis points.
- For B and C credit grades, no mortgage lates of more than 60 days.
- Debt-to-income ratio must be less than 55% no exceptions.
- No refinancing of properties listed for sale for less than 90 days.

Stated Income and No Doc Loans

The Guidance speaks to the need to underwrite stated-income loans in accordance with sound principles and practices. New Century has extensive guidelines, practices, and procedures for underwriting stated income loans.

First, consistent with the Guidance's concern over risk layering, it is important to note that our credit, LTV and other criteria for our stated income loans are tighter than they are for comparable full documentation loans. Also, consistent with safety and soundness, we have higher risk-based pricing for stated income loans compared to full documentation loans.

Second, we take a variety of compensating steps to verify the reasonableness of the applicant's stated income on our stated income loans. For example, we compare the applicant's occupation and income as stated on the 1003 form, to similar

occupations/incomes in their area. We will also consider the applicant's credit history and assets to evaluate the reasonableness of the income stated. If they appear to be reasonable, the income will be accepted. For example, we utilize resources such as www.salary.com to help us verify that the income being claimed by the borrower is reasonable based upon the business, occupation or profession provided on their loan application.

On self-employed stated loans, we also take steps to confirm that they have a business. We obtain copies of business licenses; check the phone book and/or directory assistance listings; check the business name on Lexis-Nexis, and any promotional material or advertisements that can help us verify the existence of the business. If we find that the borrower's stated income is not reasonable, we then request full documentation from the borrower.

In addition to these steps, we have recently added to our initial disclosure package and our closing document package a new notification and certification for borrowers who are obtaining a stated income loan (see Appendix 2). The initial notice informs borrowers that they have applied for a stated income loan and that they will be asked to certify that the income they provided is accurate and correct at the time of closing. It also informs them that they may get the benefit of a lower priced loan if they choose a product that requires fuller documentation of their income. The certification that is signed at closing (i) reminds the borrower that they are applying under our stated income program, (ii) states the income figure that the borrower provided in his or her application and on which we are basing our loan decision, (iii) explains that failure to accurately state their income could result in the loss of their home through foreclosure, and (iv) asks the borrower to verify that that income figure is accurate. The form also provides a number for the borrower to call if they believe they have questions about the certification or are unable to sign it.

A portion of our stated income loans are what the industry refers to as so-called stated wage earner loans, where the borrower is employed by a third party. This is a more complex area. On the one hand, those loans perform acceptably, so by and large the borrower is able to make the payments notwithstanding that they chose not to provide full documentation of their income. On the other hand, the fact that the borrower chose a more expensive loan program rather than provide full documentation of their wages begs the question why. By its very nature, data is difficult to come by in this area. Anecdotally, the reasons for electing a stated wage earner program include (i) the borrower has a spouse or significant other contributing to the payments who, for whatever reason, does not want to appear on the application, (ii) the borrower has a family member or friend as a tenant, but without a documented lease, (iii) the borrower has supplemental income that is difficult to document, (iv) the borrower is exaggerating his or her income in order to qualify for a mortgage or (v) a broker is misstating a borrower's true income, either in concert with the borrower or without the borrower's knowledge. Many of the steps we identified above are designed to mitigate the risk of (iv) and (v). And again, consistent with recognition of layered risk, our underwriting

guidelines on stated wage-earner loans are even more stringent than our guidelines for self-employed stated-income loans.

Conclusion

We applaud the Senate Banking, Finance and Insurance Committee for its approach in considering this important issue. As the Committee continues to consider how the Guidance should apply in California, we urge the Committee to keep front of mind the positive historical record of nontraditional loans. As demonstrated over many years, nontraditional mortgages have been valuable instruments for new and current homeowners and their risks have been adequately managed throughout various economic and housing cycles.

Nontraditional products offer prospective and existing homeowners the ability to attain homeownership through affordable products, allow current homeowners to consolidate other financial obligations, help improve borrowers' credit impaired histories and build financial safety nets. These products perform well in the marketplace and are adequately managed by the primary and secondary mortgage markets.

New Century believes that the Guidance put forth by the federal agencies and CSBS/AARMR, if interpreted and applied too strictly, will restrict lenders' ability to utilize the time-tested risk management practices and flexible underwriting guidelines have been so effective at improving the nation's homeownership rate. We fear that the restrictive guidelines will deter mortgage product innovation and reduce the financing options available to consumers, thereby reversing the homeownership and wealth gains made by many American families. Additionally, we fear that lenders will face more regulatory, compliance and legal uncertainties as federal and state regulators apply the Guidance to their respective regulated entities. We caution California policymakers to take a careful and deliberate approach to the Guidance as they determine whether or not to adopt it. Unlike other states, the Guidance if adopted too strictly in California could further exacerbate the state's already serious affordability crises.

Finally, we urge policymakers to refrain from including hybrid ARMs into the Guidance. These fully-amortizing products have proven themselves to be beneficial products for many prospective and existing homeowners by providing flexible, affordable access to credit.